HALBERT WEALTH MANAGEMENT

SPECIAL REPORT

From
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The Search For "Absolute" Investment Returns

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"The first rule of investment is don't lose. And the second rule of investment is don't forget the first rule. And that's all the rules there are." Warren Buffett

Introduction - What Are Absolute Returns?

Financial literature and media presentations seem to be awash with references to "absolute return" strategies. Unfortunately, most of the discussions I have seen do not define exactly what an absolute return is, or why you should want this type of return. Alas, this is just another example of the financial media sensationalizing the latest investment buzzword, without explaining exactly what they are talking about.

The term, "absolute return" is akin to the mathematical concept of an "absolute number," meaning a way to express the magnitude of a number without regard to its sign (positive or negative). It can be used to determine the distance to a point from zero, without regard to the direction. Thus, an absolute number is always expressed as a positive, so both -10 and +10 are expressed in absolute terms as just 10.

In an investment context, absolute returns means a strategy that seeks to provide consistent positive returns with minimal losses in both up *and* down markets. In mathematics, there are no negative absolute numbers, but no such magic is available in the investment context. Losses are real.

There are some absolute return strategies that are pretty much guaranteed to produce consistent positive annual returns. Savings accounts, bank certificates of deposit, money market accounts, fixed annuities, government bonds held to maturity and other similar low-risk, low-return investments will generally produce consistent positive returns. However, these returns are usually only in the range of the current level of inflation, so at best these investments generally only maintain the purchasing power of money, with little or no growth.

Absolute return strategies in the equity and bond markets seek to provide positive returns **over and above inflation,** so they are inherently subject to more risk. Thus, while the goal of an absolute return investment strategy is to produce consistent positive returns, there is no guarantee that it will do so, or that losses will be avoided. The remainder of this Report will concentrate on these non-guaranteed absolute return strategies.

The concept of absolute returns is typically used to describe the investment objectives of various **hedge funds,** since their investment goal is to produce positive returns in both up and down markets. To achieve this goal, hedge fund managers employ elaborate strategies that make use of leverage, hedging, and net short positions, among others. However, as I will discuss later on, many of these strategies are no longer limited to hedge funds.

Entire books have been written on the subject of absolute returns, especially as this term relates to the hedge fund industry. Perhaps the "bible" of absolute return publications is the classic ***"Absolute Returns"*** by Alexander M. Ineichen. In the book, Ineichen describes the mandate of most mutual funds to maintain a certain percentage of assets that are fully invested in equities at all times as being like a "car without brakes."

Since Ineichen penned those words, hedge fund strategies have proliferated to a point where some of the more aggressive strategies do not even attempt to hedge downside risk. As a result, some of the complex strategies used in today's hedge fund industry can actually subject the investor to **more** risk than if they had stayed in buy-and-hold investments. Perhaps he would call these a *turbocharged* car without brakes.

Absolutely Relative

Another way to help understand absolute return strategies is to compare them to other money management techniques that evaluate performance relative to a certain market benchmark. These **"relative return"** strategies seek to provide an investment return that is superior to a specific *market index*, or combination of indexes.

At this point, you may be wondering why anyone would care to differentiate between absolute and relative returns. After all, aren't these concepts just two variations of measuring the same thing? In other words, isn't it the goal of every money manager in the world to provide positive returns? Sadly, the answer is "no." Many money managers, especially those in the mutual fund world, are not necessarily judged by their positive results, **but by how they perform relative to their benchmark.**

Let me clarify at this point that I'm not talking about simply comparing performance to an established benchmark, which virtually all investments do to some extent. Instead, I'm referring to the evaluation of a money manager's performance as to whether or not he or she is reaching the goals and objectives outlined for the investment strategy.

When the strategy is defined as performing well compared to a specific market index, then the manager can announce that the investment "beat the market" if the performance was better than the index. However, you can beat the market in a down year by merely producing a loss lower than that of your target benchmark. Here's a good example. In 2002, the S&P 500 Index fell -22%, and many money managers boasted of beating the market because they lost "only" -10% or -15%. That's like saying it's better to drown in 2 feet of water rather than in 10 feet of water.

To be fair, however, there are times when relative returns can be superior to absolute returns. For example, relative returns are generally more favorable in periods of bull markets. Why? Because the cost of hedging or other risk management techniques to produce absolute returns lowers the potential gains available in up markets. **The only problem is that most people don't know whether they are in a bull market or a bear market until sometime after the investment decision must be made.**

To illustrate, quickly tell me whether we're in a bull or bear market right now. I'll give you a hint: For every expert you can find that says we're in a bull or bear market, I can probably find five that say the opposite. **The sad truth is that most economists and market analysts have a dreadful accuracy rate for their predictions.** They are great at analyzing data and telling you where you have been, but not so good at giving you insight about where you are right now, or where you may be going.

For a relative return strategy to be most effective, you have to be either at the bottom of a bear market, or in a continued upswing of a bull market. Unfortunately, where you are on the chart is not always clear.

To illustrate this point, I know of an investor who put money into a tech fund in April of 2000. At that time, recall that we were being told that a new economy had emerged, that the old "paradigm" was no longer valid and that increases in productivity would mean continued strong growth into the future. Unfortunately, for this investor, April of 2000 just happened to correspond to the exact top of the bull market. From the day he invested, he saw his investment plummet, eventually losing almost 70% in value. Ouch!

In fact, investment flow analysis has shown that most of the money that came into the market was at the latter stage of the bull market, in late 1999 and early 2000. Some of these investors did not have the benefit of riding the market up during the 80s and 90s, but did get to participate in all of the downside of the bear market. In other words, they chose a relative return strategy at the worst possible time, but only 20/20 hindsight reveals this fact. At the time they invested, they thought they were buying into a continuing bull market.

The moral to the story is that, despite what you might be told by direct mail and Internet "experts," you never know exactly what kind of market you happen to be in at the time. **At any given point, you may find yourself investing at the top of a bull market, bottom of a bear market, or anywhere in between.** That being the case, absolute return strategies are sometimes the best way to go, especially if you cannot risk losing a large portion of your investment.

Relative Returns & Index Funds

I have shown how a relative return manager can still brag about beating the market even though producing consistent losses, as long as those losses are less than those experienced by a specified benchmark. However, don't hold this against the financial services industry alone; it was helped along this path by investors and a new invention called "index funds."

In the late 1990s, the stock markets were headed straight up. Virtually any stock was setting new price records, and successful initial public offerings (IPOs) were being conducted for high-tech businesses with no revenue, no profits, no experienced management, and little more than a business plan.

Investors, already drunk on the wine of a 10+ year bull market, decided that the markets should go up at least 20% to 25% every year, and any fund manager that couldn't keep up with this should be punished by losing all of the assets he or she managed. Thus, many money managers (not all, mind you) realized that the value of their services was determined based upon how they performed relative to the market as a whole or some underlying index.

As a result, many fund managers simply "bought the index" by which they were judged. This means that they filled their funds with stocks that would perform in lockstep with the underlying benchmark index. Studies conducted at the time documented the practice, finding that many popular mutual funds had a very high degree of correlation with the market indices, and generally underperformed the market by the amount of their management fees and expenses.

The widespread introduction of index funds in the mid 1990s didn't help things either. These funds are designed to approximate the return of an underlying index, at a fraction of the cost of a traditional mutual fund. Many investors heeded the siren song of low-cost index funds even though doing so subjected them to far more risk than they could have imagined.

As active money managers sought to defend themselves against these low-cost rivals, the industry generally took its eyes off of fundamental analysis and absolute returns, and in doing so did not anticipate the cliff they were about to fall off of in the form of the bear market of 2000 through 2002. During this time, the S&P 500 Index lost over 44% of its value, and the Nasdaq Composite Index lost over 70%.

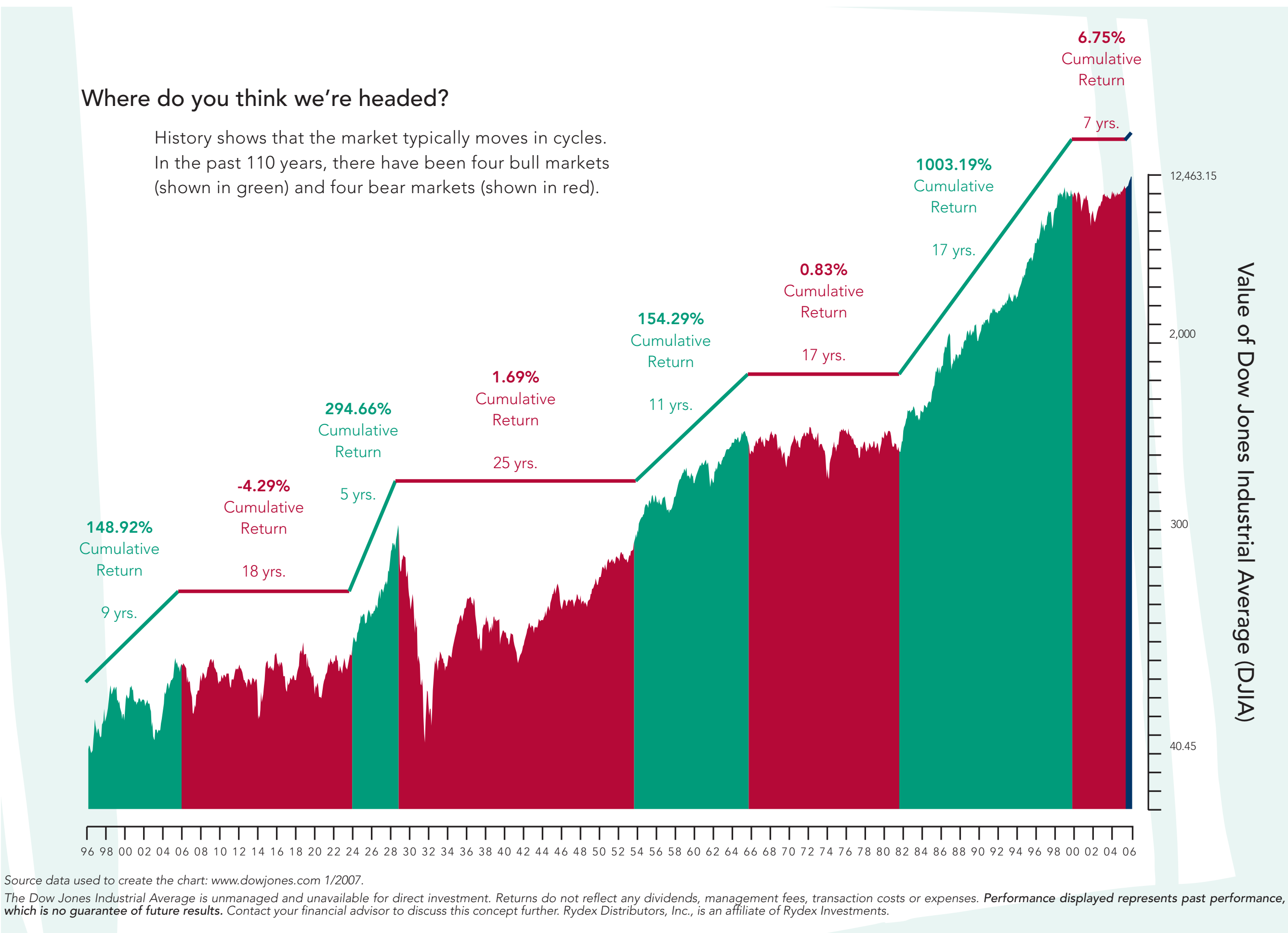
Funds pegged to these market indexes lost similar amounts, in addition to the fees they charged to oversee this calamity. **Worst of all, it took the S&P 500 Index over seven years to fully recover its losses, and the NASDAQ Composite is <u>still</u> underwater.**

The Fallacy Of Extended Time Periods

At this point, confirmed relative return investors will say that the above example is unfair, in that it shows results over just a short period of time. Over longer periods of time, statistics show that the stock markets will produce positive returns greater than those available from alternative strategies. All you have to do is hold on.

To prove their point, they will drag out charts and graphs of the market's performance over 75 or 100 years. These are very nice graphs, and I think they are pretty, but they are irrelevant. **Investors with 75-year time horizons are either not yet born, or are in their infancy; either way, they're a hard audience to reach.**

Most people in the real world have much shorter time horizons than 75 or 100 years. They turn 40 or 50 years of age, and finally decide that they had better start thinking about retirement. Or, they want to fund a child's college education. Unless you are an institutional investor or setting up an estate for future generations, your investment goals will likely require a holding period of far less than 75 years. Over the course of the last 100 years, there have been numerous times when the market went nowhere for extended periods of time.



(Figure 1)

One of the best barometers for long-term market performance is the Dow Jones Industrial Average. Created in 1902, it has provided a continuous record of the stock market's health for over 100 years. I recently reviewed the 100-year chart of the Dow Industrials (See Figure 1) illustrating bull and bear market cycles. Over this extended period of time, the market did generally increase. However, there were multiple bear market cycles where the market dropped drastically, and then took years to climb back up to its previous high point. The longest of these recovery periods lasted 25 years, and the shortest was 17 years.

Note in the preceding chart that the latest bull market phase was an 18-year span that lasted until April of 2000. If history repeats itself (which it usually does), the recovery period for the latest bear market that began in 2000 could have a decade or more to run. Do you need your investments to grow in the next 17 to 25 years? **If so, a relative return strategy may not be your best option.**

Why <u>You</u> Should Pursue Absolute Returns

Perhaps the best argument against relative return strategies is that they bear no relation to your individual investment goals and risk tolerance. The best true benchmark for any investor is the amount of return needed to meet the specific goals for the investment, not an artificial index. **Thus, your absolute return benchmark becomes either the risk free investment return, or the target return to meet your investment goals. All other benchmarks become irrelevant.**

Therefore, the important thing is to invest in a strategy that is designed to produce potential gains in line with what you need to achieve your investment goals, and not subject your portfolio to undue market risks. Remember what Warren Buffett says, the first rule of investing is not to lose money.

Nowhere is the idea of risk management better represented than in the realm of hedge funds. Therefore, perhaps it would be instructive to see just why hedge funds, and thus absolute return strategies, have become so popular.

We all know that hedge funds are usually available only to wealthy investors, generally those with a net worth well over $1 million. Yet, we also know that hedge funds are one of the fastest growing investments. What do these wealthy people know that you don't? What investment goals do they have, and how do hedge funds satisfy these goals?

It may come as a surprise to you, but many wealthy investors have the same basic investment goals as the average investor. They want their money managed in such a way as to produce consistent positive annual returns, but they don't want to take the risk of losing too much in the process. One important difference, however, is that most wealthy investors have more realistic return expectations. They know that reaching for higher returns involves more risk, so they seek strategies that can provide reasonable returns while also attempting to maintain relative safety of principal.

This makes sense, since most wealthy individuals got that way not from investing, but from building businesses or accumulating money over a long period of time, such as in a retirement plan. When they sell their businesses or take a lump-sum distribution from their retirement plans, these amounts represent the culmination of a lifetime of hard work. These assets also represent money that probably can't be replaced, since the individual can't go back in time to build another business or accumulate another retirement nest egg.

Therefore, wealthy individuals seek out hedge funds because the managers of these investment products understand the need to manage the downside risks inherent in the stock and bond markets, and also the need for real returns to stay ahead of inflation.

Essentially, most other investors have similar goals in mind with regard to their investments. However, their goals and actions typically head in two different directions. Numerous studies have shown how individual investors will chase the latest hot stocks or mutual funds seeking to pump up returns, yet they often end up losing more than they gain.

Just as I discussed earlier about those who got into the tech bubble in late 1999 or 2000, most investors come late to the party. By the time they are convinced that an opportunity is "for real," it is likely near the end of its run and may soon begin to decline. This is especially true when chasing the latest hot mutual fund. Most funds at the top of the performance list at the end of a year experience such huge inflows of funds that they find it difficult, if not impossible, to repeat their superior performance. Obviously, there are exceptions to this rule, but they are rare.

The Mathematics Of Negative Returns

On the cover page of this Special Report, I included a now-famous saying by Warren Buffett, arguably one of the most successful investors in history. It might be instructive to discuss exactly why he is so adamant that losses should be avoided.

There are some investors who appear to be of the "no pain, no gain" school of investing, in that they figure they must take on a lot of risk to meet their investment goals. The problem with this approach is that while they may be able to get above-average returns along the way, they also subject themselves to the potential for severe losses.

What Mr. Buffett knows is that when these inevitable losses occur, it takes a much higher return to get back to where you were before the loss was incurred. For example, if you lose 20% in the market, you have to earn 25% just to get back to breakeven. The table below illustrates this idea more clearly:

Amount of Loss Incurred	**Return Required To Break Even**
10%	**11.1%**
15%	**17.7%**
20%	**25.0%**
25%	**33.3%**
30%	**42.9%**
35%	**53.9%**
40%	**66.7%**
45%	**81.8%**
50%	**100.0%**
60%	**150.0%**
70%	**233.3%**

(Figure 2)

Note that if you lose 30%, you have to make almost 43% ***just to get back to breakeven.*** Lose 50% and you have to make 100% ***just to get back to breakeven.*** The table above should clearly illustrate to anyone that avoiding large losses is the most important objective of any worthwhile investment strategy.

Active Management Strategies & Absolute Returns

There are few unqualified statements you can make in regard to the investment industry, but I think I'm safe in saying this one: **To attempt to achieve absolute returns in the equity markets, I believe you must employ active management techniques.** As a general rule, the only way a relative return strategy can produce consistent positive returns is for the overall market to be trending upward.

At this point, it is probably best to define exactly what I mean by an "active management strategy." In a nutshell, active management means the money manager actively shifts assets from one asset or asset class or market to another. In the classical definition of active management, this means buying and selling stocks or bonds with greater upside potential in an effort to outperform a specified market index, or to produce absolute returns.

However, true active management can involve a lot more than trading stocks. In the context of providing absolute returns, active management may mean moving from one stock position to another, but it could also mean moving from a long position to cash, or even shorting the market. It might also mean moving from one market sector to another, or one asset class to another. There is no "cruise control" with these active management strategies. The daily involvement of the money manager is imperative to the success of the strategy.

In contrast, **passive management** is an attempt to duplicate the performance of an index or maintain a strict asset allocation among asset classes. Investing in the various index mutual funds is a perfect example of passive management. Some consider periodic rebalancing of passive portfolios to be evidence of active management, but such is not the case. Rebalancing a portfolio to revert back to the original asset allocation percentages is simply enforcing its passive approach.

Since absolute return strategies seek to provide positive returns in both up and down markets, common sense dictates that they must adjust their strategy depending upon the market environment at any given point in time, and this is a hallmark of active management.

Types of Active Management Strategies

As I have discussed throughout this Report, absolute return strategies, and thus active management, are typically found inside hedge funds that are unavailable to most investors. However, many of the same strategies found in sophisticated hedge funds are also available to investors with even modest nest eggs. The remainder of this Report will concentrate on the programs available to all investors through accounts managed by Investment Advisors.

There are a number of active management strategies available to investors today, but all have the common denominator of moving money from one asset to another in an effort to maximize risk-adjusted returns. The types of securities traded by these strategies run the gamut from individual stocks and bonds to mutual funds, exchange traded funds (ETFs), and even short positions.

It is important to note that, while virtually all absolute return strategies employ active management, not all active management strategies result in absolute returns. There are some active management strategies with the goal of reducing market risk while being fully invested in the market at all times. In such strategies, a down market will produce losses in these active management strategies, though they should be less than those experienced in the overall markets.

A common thread in all active management strategies is a proprietary system for determining the direction of the market and which securities should be bought or sold. These systems are typically based on one or more analysis techniques including momentum investing, trend analysis, technical analysis (charting), money flow analysis, or even manager discretion. Some managers even use contrarian analysis, which seeks to find out what everyone else is doing, and then do just the opposite. Each of these analysis techniques could be listed below as an active management strategy on their own. However, since these techniques are often used within active management strategies, I will not list them separately.

Some of the more common varieties of active management include:

1 **Fundamental Analysis** - This is essentially what some traditional mutual fund managers were supposed to be doing when they were actually "buying the index" as I discussed above. Fundamental analysis is a "bottom-up" approach to investing where the money manager evaluates each security on its own merits, and buys or sells accordingly.

Unlike some of the other active management strategies discussed below, fundamental analysis is based on the intrinsic value of the individual security being considered for investment.

This strategy is sometimes identified as a buy-and-hold approach, but if properly executed, is anything but buying and holding. While positions are usually held longer in this type of strategy, changes in the fundamentals of a stock or bond will result in appropriate changes to the portfolio.

Fundamental analysis is one of the strategies that won't necessarily make money in down markets. While every effort is made to select stocks that will hold value, market declines frequently affect all stocks, even those with good fundamentals. In such cases, fundamental managers will often take advantage of lower prices and actually buy more of their favorite stocks, figuring that the next upswing in the market will produce a greater gain for a stock with good fundamentals than the increase in the market as a whole.

2. **Traditional Market Timing** - Traditional market timing has been around for a long time. It involves buying securities when they have the potential for gains, and going to cash or hedging when down markets are anticipated. Individual investors sometimes engage in market timing when they move in or out of the market based on emotions. Unfortunately, emotion is usually a poor guide to market risk.

In contrast, the professional market timing manager makes buy and sell decisions based on a methodology usually developed after extensive observation, study, and testing. The basis of the system may be technical analysis, fundamental analysis, or a combination of these and other techniques.

At this point, you might ask how going to cash can produce gains in down markets. The answer is that no market ever goes straight up or straight down. There are many up days in bear markets and down days in bull markets.

Successful market timers seek to be on the sidelines during down days, and then go back into the market when they perceive a potential for gain. **Doing so can produce absolute returns, even though the general direction of the market is down.**

Obviously, no manager is perfect in this endeavor, but one who can produce more winning trades than losing trades can potentially add value and provide absolute returns to investors.

Wall Street's Flawed Theory On Market Timing

As you might suspect, Wall Street and the major financial media have dismissed market timing for years and have roundly criticized its proponents. Most brokerage firms and mutual fund companies have a stock answer for market timing - ***Don't try it!*** **However, their most popular argument against market timing is badly flawed!**

Wall Street's story goes like this: Historically, much of the stock market's upward moves are concentrated in a relatively few number of days, which is true. If a money manager takes you out of the market, and you miss some of those good days, then your returns will suffer dramatically. Therefore, they say, it is important that you stay in the market so that you will not miss these good days. In other words, moving in and out of the market is bad.

One such study that supports this view analyzed stock market performance over a period from January of 1982 through December of 2006. **Over that period of time, the S&P 500 Index produced an average annual return of 10.28% (excluding dividends). However, the study shows that if you missed the 10 best days in the market over that period, your return fell to 7.93%.** Here again, these numbers are accurate but also very misleading, as we will see below.

Missing even more of the best days means even lower returns. For example, **if you missed the 40 best days in the market, your average return would only have been 3.33%.** Thus, Wall Street reasons, if you want to maximize your returns, you have to stay in the market at all times so that you don't miss the good days.

While the numbers they quote are accurate, this analysis is obviously skewed to fit the viewpoint of the buy-and-hold crowd. **It is flawed because it assumes that a market timer would be *out* of the market on the best days, but *in* the market on all of the worst days.** Unfortunately, many investors buy this argument hook-line-and-sinker without thinking to ask the question,

"What happens if you miss the bad days in the market?"

The **National Association of Active Investment Managers (NAAIM)**, a trade association of professional money managers, saw the obvious fallacy in the above argument and did further analysis that paints an entirely different picture. Instead of missing the good days in the market, let's say that an Advisor allows you to miss only the **worst** days in the market. Using the same data as above from January of 1982 through December of 2006:

If you missed just the 10 worst days in the market, your average annual return would have been 13.88% versus the 10.28% S&P 500 Index return.

Now that's impressive! As you increase the number of worst days missed, the numbers get even better, resulting in an average annual return of **18.80%**, if you missed the worst 40 days in the market over this period of time.

Of course, this analysis is just as flawed as Wall Street's skewed analysis, since it assumes that the Advisor is smart enough to be out of the market on all the worst days, but in the market on all of the best days. Obviously, this is not possible.

Since both sets of performance numbers discussed above are skewed to fit one approach or the other, neither is useful to the knowledgeable investor. However, NAAIM continued in their study to see what would happen if an Advisor missed ***BOTH*** the best and worst days in the market over the time period discussed above. The results are pretty amazing.

> **If you missed the 10 best AND 10 worst days in the market, the resulting return would have been 11.14% on average as compared to the 10.28% S&P 500 Index return. As the number of best and worst days missed is increased, the differential in returns remains about the same, so missing the 40 best and worst days results in a return of 11.34% versus 10.28% for the S&P 500 Index.**

The table below shows performance differentials for all of the scenarios discussed above:

If you missed just the best:	**Your return fell to:**
10 days	**7.93%**
20 days	**6.22%**
30 days	**4.71%**
40 days	**3.33%**
If you missed just the worst:	**Your return rose to:**
10 days	**13.88%**
20 days	**15.75%**
30 days	**17.35%**
40 days	**18.80%**
If you missed best and worst:	**Your return was:**
10 days	**11.14%**
20 days	**11.50%**
30 days	**11.44%**
40 days	**11.34%**

(Source: NAAIM, Inc., based on an analysis performed by Hepburn Capital Management, LLC, 805 Whipple St., Suite D, Prescott, AZ 86301. This data is for illustrative purposes only and is not indicative of the actual performance of any investment. S & P 500 Index returns do not reflect reinvested dividends.)

Thus, while the average annual return percentages showed the results of the bear market, the basic result stayed the same: **Missing bad days in the market can more than compensate for missing out on the good days.** Even when the general direction of the market was downward, missing out on the worst declines still proved effective in enhancing performance.

It is important to put this statistical study in perspective. While it may be the goal of every active manager to be in the market only on the good days and out of the market on all of the bad days, we all know that such a perfect system doesn't exist. **However, the ultimate goal of a market timing strategy is not necessarily beating the market, but to attempt to minimize the downside risk of being in the market and produce absolute returns.**

3. **<u>Hedged Strategies</u>** - Hedging strategies in business have been practiced for centuries, but common usage in money management is a fairly recent innovation. Active management strategies employing hedging techniques came into their own in the late 1940s with the introduction of the first "hedge fund." Today, they extend even to the mutual fund industry. There are a number of different hedging strategies and techniques, and to try to discuss each in detail is far beyond the scope of this Report.

   However, as a general rule hedging strategies differ from market timing in that rather than going to cash, they seek to reduce the risk in the market by employing a defensive strategy. Early on, the primary defensive strategy was to sell short a group of stocks within an industry or index. However, recent years have seen a proliferation of financial instruments that can be used to hedge the overall market.

   These complex financial instruments have now made it possible for mutual fund families such as Rydex, ProFunds and Potomac, to develop specialty mutual funds that can short specific market indexes.

   In practice, a money manager using hedging techniques might identify stocks or mutual funds with the potential for superior performance. To hedge the long positions, the manager might short a basket of stocks, or purchase one of the special "inverse" funds that provide a short exposure for a specified index. **The hope is that the short position balances the general market risk, and the superior fundamentals of the selected long positions will produce gains.**

   While hedging can be a very effective strategy, it is important to note that no hedge is perfect. Nor can hedging make up for poor judgment on the long positions held. Hedging strategies can also be very complex to understand, especially when some of the more sophisticated financial instruments are employed.

4. **<u>Long/Short Strategies</u>** - A long/short strategy is pretty much exactly what the name implies. The Advisor attempts to determine the overall direction of the market, and then invest in long positions when the market has upside potential, and short positions when the market is expected to decline. In contrast to hedged positions, most long/short managers will either be "net long" or "net short" in the market rather than attempting to build a hedged portfolio. In times when the market's direction is not clear, the long/short manager will stay on the sidelines in cash.

   Long/short strategies can typically "turn on a dime," switching from long to short to cash and back again very quickly. For those managers using individual stocks, today's Internet trading technology allows them to execute a number of trades within a single day, spawning the term "day trader."

   Most professional money managers using a long/short strategy do not attempt to day trade, but look to exploit trends in the market. Many utilize the specialty long and short index funds previously discussed in this Report to gain access to both long and short exposures. The availability of these funds also allows the manager to trade on a daily basis without running afoul of frequent trading limitations or early redemption fees found in traditional mutual funds.

While long/short strategies offer the most direct route to potential absolute returns, they are also among the most risky. The reason is that wrong calls by the money manager can cause the portfolio to be "whipsawed" in volatile markets. Being whipsawed can be best described as rapid-fire buying high and selling low.

5. **Sector Rotation** - Money managers who practice sector rotation seek to move among the various industry sectors depending upon the potential for gain in each. The rationale behind this strategy is that there are always some sectors that do better than others, even in down markets. Accurately defining the best sectors can potentially produce absolute returns where buy-and-hold in a single fund or index could lead to losses.

   A "sector" is simply a group of stocks sharing similar characteristics, in this case the industry represented. Standard & Poors has broken the stock market up in to 11 different sectors, as follows: utilities, consumer staples, transportation, technology, health care, financial, energy, consumer cyclicals, basic materials, capital goods, and communications services. Other financial services companies may have different breakdowns, but they all seek to categorize stocks by industry.

   In a sector rotation strategy, the money manager will move assets to the sector or sectors with the most potential for gain. Money will remain within a sector as long as the manager feels there is potential for gain. When a sector is no longer favorable, the manager rotates the assets to another sector with more favorable valuations.

   Sector rotation can be accomplished through both individual stocks and mutual funds. In down markets, there are times when no market sector is favorable, and this can lead to losses, though the hope is that the manager has allocated assets to those sectors experiencing the least downside volatility. However, there are some variations of sector rotation in which the manager will allow all or part of the portfolio to be held in cash when all sectors are in decline. There are even some managers who will enter into short trades on those sectors he or she feels are weakest, while maintaining long positions in the strongest sectors.

   As with the other active management strategies, the money manager's decisions in regard to the appropriate sector or sectors with potential for gain are derived from a proprietary methodology based on market analysis. However, this analysis is based on the outlook for a specific industry segment rather than any intrinsic value the individual stock may have.

6. **Tactical Asset Allocation** - Unfortunately, this term has been attached to a number of different money management strategies, and has even been used to collectively describe all active management strategies. However, in this Report I will use this term to mean a method of investing that involves moving assets among various asset classes based on the expectation for gain.

   In this context, tactical asset allocation is similar to sector rotation in that assets are being moved among a subset of the stock market, either through individual stocks or mutual funds. The difference lies in tactical asset allocations movement among various asset classes, which are not the same as market sectors.

Asset classes are defined as categories of investments, such as stocks, bonds, real estate or foreign securities. Even within these broad categories, there can be further breakdowns. For example, within the stock category, you may have large-cap, mid-cap and small-cap stocks. And even these may be further broken down into "growth" or "value" categories.

Analysis has shown that the various asset classes vary in return potential in different market environments. For example, large-cap stocks dominated the market in 1995 - 1998, while small-cap stocks have been the top performers in five of the last six years since then. The tactical asset allocation manager seeks to determine which asset class will perform best in the current market environment, and invests accordingly.

Like sector rotation, tactical asset allocation is based on factors other than the intrinsic values of the securities purchased. It differs from sector rotation, however, in that the category of security (asset class) is deemed to be a better indicator of future value than its broad industry classification.

Obviously, the above list of active management strategies is not meant to be exhaustive, as new and different approaches to the market are developed all the time. The brief descriptions of these strategies are not intended to fully explain all of the nuances of each particular strategy, but are designed to provide a basic sketch of each risk management technique. There are entire books written about each strategy, and literally thousands of Investment Advisors practicing them on a daily basis.

The HWM AdvisorLink® Program and Absolute Return Portfolios - Your Keys To Managing For Absolute Returns

In this Special Report, I have tried to communicate three major concepts:

1. **Absolute return strategies are often superior to relative return strategies, in that they seek to provide stable, positive growth rather than being subject to as many of the ups and downs of the markets;**
2. **Relative return strategies can lead to investment losses that can be devastating to your portfolio and prevent you from reaching your investment goals; and**
3. **Active management strategies are a key component in obtaining absolute returns.**

At this point, you should agree with me that there is a compelling case to include active management strategies in your portfolio. The future of the investment markets is always uncertain, but based on historical precedent, we could be in for a long stretch of time where the market simply goes sideways.

So, how can you access these absolute return strategies for your own portfolio?

I'm glad you asked! My company has developed two investment programs that seek to generate absolute returns through active management strategies. The ***AdvisorLink®*** Program is a managed account strategy using third party professional money managers that have met our strict due diligence criteria. Our **Absolute Return Portfolios** are a set of pre-selected mutual funds that have historically generated absolute returns in both up and down markets. Of course, there is no guarantee that they will always be able to do so.

Each of these programs approaches the goal of absolute returns differently, which allows you greater diversification in your overall portfolio. In the remainder of this Special Report, I will discuss both of these programs in greater detail, and show you how to take advantage of their strategies to add diversification to your portfolio.

The *AdvisorLink®* Program

In 1995, at the request of my clients, I began our ***AdvisorLink®*** Program. In essence, the service we provide is as a **"manager of managers,"** meaning that we don't manage the money directly, but seek out and monitor successful money managers to manage our clients' money. To do this, we continually monitor and evaluate the universe of professional money managers. From that universe, we identify the more successful Advisors based upon detailed performance and business information they provide us.

There are many professional Investment Advisors that use active management strategies. But as is true with other types of money managers, there are some really bad ones, some mediocre ones and only a relatively small number of very successful ones. Thus, the selection process is not easy.

Once you find a candidate, you have to ask questions such as: How long have they been in the money management business? Do they have an actual track record with real money or are all their impressive results just hypothetical, "paper trading" results? How much money do they manage? Do they have a strong "back-office" to be able to handle the administration of the accounts they manage? And perhaps most important of all, how much of their own money do they manage in their programs? These are just a few of the critical questions you need to ask.

Also, is it necessary to actually visit the Advisor's office in person? I believe it is, but this can be very expensive and time consuming. **At HWM, we do an advance on-site due diligence visit for EVERY Advisor we recommend to our clients.**

There is no way that I can adequately explain all that is required to thoroughly evaluate an Investment Advisor in this limited space. Suffice it to say that evaluating a money manager goes far beyond analyzing his or her track record. Though many investors are familiar with the research necessary to identify stocks worthy of investment, not many know the special considerations necessary to determine whether professional money managers add value above and beyond the fees charged for their services.

That's where Halbert Wealth Management comes in. We have been evaluating money managers for over 20 years, and have developed our own proprietary due diligence process. Our evaluation delves not only into a prospective Advisor's performance data, but also into the background of its principals, its detailed strategy, administrative capacity, and even significant life events that may affect the ability of key personnel to manage money effectively.

Ongoing Monitoring Is Critical

Even professional money managers, including those who have met all of our due diligence criteria, can experience problems and must be monitored continually. Occasionally, the problems are serious enough that the Advisor has to be terminated from our list of recommended programs. Some Advisors let their emotions get in the way and they override their trading system. Others have changed their trading system to the point that it is a virtually new strategy with no realistic performance record. Still others have systems that are designed for a certain market environment, such as a bull market, but won't work well in other market environments.

It is also true that a successful historical track record is no guarantee of future performance. Since 1995, we have looked at hundreds, if not thousands, of potential money managers. We have hired some very impressive names in the business, and all of these had excellent credentials and impressive track records. Even so, there have been occasions when a previously very successful Advisor encountered a market environment that prevented their strategy from being effective, and they experienced losses. There have been times when we have recommended that our clients move their accounts to other Advisors.

This is a very important point. **There are very few money managers who will ever advise a client to close his or her account. In most cases, a struggling money manager will strongly encourage clients to "hang on" until things get better.** Often, they will tell clients that they've made important changes which should improve performance. The client, who may not be qualified to evaluate the manager's story, may be convinced to hold on, and more losses could follow.

That's where I see the true value of a program like ***AdvisorLink®***. We monitor all of the Advisors we recommend on a daily basis to see if they are performing acceptably. How do we do that? **I have personal accounts with every Advisor we recommend.** By monitoring my accounts each day, we can see how the Advisor is doing.

We can also see if there are changes in the performance patterns. In addition, we talk to the Advisors on an ongoing basis. Some Advisors prefer not to talk to individual clients, but because we represent a large block of clients, the Advisors are happy to take our calls and answer our questions. The good ones are also happy to have us come for on-site due diligence visits.

> **The point is, we stay on top of the Advisors we recommend, and if ever there is a reason to get out of any of these programs, we will tell you. This means that we sit on your side of the table, not the Advisor's. If we think an Advisor needs to be fired, we will tell you right away.**

How *AdvisorLink®* Works

As noted above, there are many different types of active management strategies, and we try to have many of them represented in our ***AdvisorLink®*** Program. However, we will never include an Advisor just because he or she fills a particular strategy niche. **At HWM, we don't tend to favor one style over another; we focus on performance, with particular emphasis on risk management and absolute returns.**

Most of the Advisors we recommend specialize in equity mutual funds. However, we also recommend outstanding programs that use either bond mutual funds or individual bonds. The minimum investment for the various Advisors we recommend ranges from as low as $25,000 up to $200,000.

The Advisors we recommend range from moderate to aggressive risk. As a result, we help prospective clients determine which programs may be most suitable in terms of their financial goals and risk tolerance. In many cases, a combination of programs produces the optimum portfolio with low correlation and strong historical performance. However, it is important to remember that past performance is not necessarily indicative of future results.

Once an Advisor(s) is selected, clients are provided paperwork to open their own individual accounts at the independent custodian (trust company, brokerage firm or mutual fund family) selected by the Advisor. The Advisor is given a limited power of attorney to make purchases and sales of selected securities in the account based on the "buy" and "sell" signals generated by its time-tested system.

Clients receive regular statements showing the activity in the account(s), gains or losses and any fees paid to the Advisor. Professional active managers typically charge annual management fees of 2-2½%, usually billed quarterly. The Advisors share a portion of their management fees with HWM for introducing the client, and ongoing client services. (So, by using HWM, clients should pay no more in management fees than if they were to contact the Advisor directly, plus they get the benefit of our ongoing monitoring and our constant search for new Advisors.)

Note that we always present performance information <u>net of all fees and expenses</u>, so you are better able to evaluate whether an Advisor is adding value over and above the fees charged.

The Absolute Return Portfolios

As noted above, the ***AdvisorLink®*** Program offers managed accounts that seek to maximize absolute returns through the active management of mutual funds and other securities. However, recent actions by some mutual fund companies now discourage moving in and out of certain types of funds. Plus, there are some investors who simply do not wish to engage in frequent trading, or desire a more tax-efficient investment alternative.

Fortunately, there are mutual fund managers who have built impressive records of producing positive gains in different types of market environments. While these may not always be the top yearly performers, they have historically offered consistent returns over and above those of "risk-free" investments such as fixed annuities and money market funds.

In addition, thanks to changes in the ways mutual funds can invest, some fund managers have been able to incorporate active management techniques and strategies into their mutual funds. That includes the ability to go to cash in down markets, and even the ability to enter into short trades in declining markets. While many of these actively managed mutual funds do not yet have long track records, there are a select few that have five or more years of past performance that illustrates their ability to control risks. Of course, past performance does not guarantee future results, but it can give us an idea of how the managers deal with investment risk within the funds.

Taken individually, these funds might have risk characteristics that would make them unsuitable for a risk-managed portfolio, but in combination with other non-highly correlated funds, the overall portfolio may exhibit less market volatility. As a general rule, these funds have been successful in the past by employing active management strategies similar to those used by the money managers in our ***AdvisorLink®*** Program. Past results are not necessarily indicative of future results.

Using our sophisticated mutual fund analysis software, we examined the mutual fund universe, looking for mutual funds that I would characterize as ***"Steady Eddie"*** funds - those that have delivered good returns (although not necessarily the highest) through various and different market environments with limited drawdowns. Once potential candidates were identified, we then ran various combinations of these funds inside a single portfolio, in an effort to further enhance potential performance and reduce the risk of loss. The culmination of all of this research is now available to our clients in the form of our **Absolute Return Portfolios.**

Investors who wish to take advantage of the **Absolute Return Portfolios** will have the choice of three different risk categories - ***Moderate, Moderate-Plus*** and ***Aggressive.*** There is a slightly different mix of funds (5-6) in each category, but the objective of each portfolio is to produce a target level of absolute returns while keeping risk within certain limits. The risk categories and target returns for each portfolio are discussed in more detail below:

Absolute Return Moderate Portfolio: The goal of the Moderate Portfolio is to produce average annualized returns in the 6% - 8% range net of all fees and expenses over time. The Moderate Portfolio seeks to limit risk, as measured by maximum drawdown, to -10% or less at the portfolio level. We seek to accomplish this level of risk-managed returns through the use of actively managed mutual funds that may employ fundamental analysis, traditional market timing and some hedging strategies. This portfolio is generally suitable for investors who have a moderate risk tolerance and return expectation.

Absolute Return Moderate-Plus Portfolio: The Moderate-Plus Portfolio seeks to produce average annualized returns in the 8% - 10% range, net of all fees and expenses, while limiting drawdowns to no more than -12% at the portfolio level. The funds used are the same as those in the Moderate Portfolio, plus an additional fund that incorporates a more aggressive active management strategy such as the use of net "short" trades, futures and options, or more aggressive hedging techniques. The addition of a fund using a more aggressive active management strategy makes this program generally more suitable for investors with a moderate to aggressive risk tolerance.

Absolute Return Aggressive Portfolio: As its name implies, the Aggressive Portfolio seeks to produce a higher rate of return, but with greater risk potential as well. The Aggressive Portfolio's target return is 10% - 12%, net of all fees and expenses, while seeking to hold drawdowns to - 15% or less at the portfolio level. The Aggressive Portfolio has a larger number of mutual funds that may engage in aggressive active management strategies, including net "short" trades, leverage, or exposure to the commodities markets. Accordingly, as a general rule, only investors with an aggressive risk tolerance should invest in this portfolio.

It is important to note that, while there is an average annualized return and maximum drawdown target for each of the **Absolute Return Portfolios**, there is no guarantee that any of these portfolios will achieve these targets. However, HWM will continue to monitor these programs both at the individual fund and portfolio levels in order to identify any deviations in their performance criteria.

In traditional asset allocation programs, the investment portfolio is allocated into mutual funds based on the historical performance of the particular asset classes represented. At HWM, we feel that these asset allocation strategies typically reward the strongest recent performers, which may or may not be the strongest future performers. Since traditional asset allocation also seeks to combine "uncorrelated" asset classes, it may recommend an asset class that might be unsuitable for some investors.

That's why in the **Absolute Return Portfolios**, we allocate funds to each mutual fund in equal amounts, without regard to its asset class or historical performance. Periodically, the portfolio may be rebalanced to retain the equal weighting, but this will be done only when the amounts involved make it advisable in light of any minimum additional investment requirements and/or brokerage fees that may be charged.

The minimum required to invest in our **Absolute Return Portfolios** is only $15,000. Individual accounts are opened at TD Ameritrade where the funds will be purchased and held. TD Ameritrade will provide periodic brokerage statements and annual tax information mailed to you at your address of record. You also have the ability to access your account information on a daily basis using the TD Ameritrade website.

HWM receives no compensation from TD Ameritrade in the form of commissions, 12b-1 fees or any other fees or commissions. Fees for our services are charged at a rate of 1.25% on the first $100,000, 1.00% on $100,001 to $1,000,000 and 0.75% thereafter. Fees are automatically withdrawn from the TD Ameritrade account semi-annually. As with the ***AdvisorLink®*** programs, all performance information for the **Absolute Return Portfolios** are provided net of all fees and expenses.

As you review the **Absolute Return Portfolio** information, it is important to remember that any mutual fund investment carries a risk of loss, and that past performance is not necessarily indicative of future results. Also be sure to read Important Information included on Page 4 of each Portfolio Profile.

Conclusions

In this Special Report, I have sought to present the concept of absolute returns through active investment management as a means to potentially smooth-out your investment returns and control portfolio risk. In the past, these strategies were generally known only to the wealthy, who accessed them via hedge funds and other specialized investments. Yet, while Wall Street was courting wealthy investors with absolute return strategies, it was trying its best to convince average investors that buy-and-hold asset allocation strategies were the way to go.

Only after the bottom fell out of the market during the 2000 - 2002 bear market did investors begin to realize that Wall Street was out of touch with what investors really needed - <u>consistent positive investment returns</u> at a level necessary to meet their personal financial goals.

Fortunately, some of us in the investment business recognized the folly of relative returns early on, and have been actively pursuing absolute returns. As a result, almost any suitable investor can now incorporate these strategies into a diversified portfolio at minimum investments far less than the millions of dollars sometimes required in those offerings tailored for the wealthy.

I encourage you to check out the professional money managers featured in our ***AdvisorLink®*** Program as well as our **Absolute Return Portfolios**. After all, what do you have to lose in looking at these programs? At worst, you may choose not to invest and you've only spent a few minutes of your time to review the materials. More likely, you may find a risk managed way to invest that might mean the difference between meeting or not meeting your personal financial goals.

In closing, I would never recommend an investment program to any of my clients that I do not invest in personally. I have my own money invested alongside that of my clients in every program we recommend. And these are not just small test accounts. I have the bulk of my net worth invested in the very same programs that I recommend to you. Thus, when I tell you we'll look after your money just as if it were our own, it's because part of it IS our own.

If you are ready to get away from the stock market roller coaster and invest in active management strategies designed with the potential to produce absolute investment returns, I invite you to contact one of HWM's Investment Consultants by calling **800-348-3601** , or by e-mail at **<u>info@halbertwealth.com</u>**. You can also learn more about our investment programs by going to our website at www.halbertwealth.com. Please be sure to read the Important Notes on the following page, and for each program before you decide to invest.

IMPORTANT NOTES: Halbert Wealth Management, Inc., is an Investment Advisor registered with the Securities and Exchange Commission. Information in this report is taken from sources believed reliable, but its accuracy cannot be guaranteed. Any opinions stated are general observations, not specific or personal investment advice. Please review Halbert Wealth Management's ADV Part II and all Important Notes for each program before making a decision to invest.

Securities trading is speculative and involves a substantial risk of loss. Any investment in a mutual fund carries the risk of loss. Mutual funds carry their own expenses that are outlined in the relevant mutual fund's prospectus. AdvisorLink and the Absolute Return Portfolios ("the Programs") are not bank accounts and they are not guaranteed by FDIC or any other governmental agency. In addition, you should be aware that (i) the Programs mentioned are speculative and involve a high degree of risk; (ii) their performance may be volatile; (iii) an investor could lose all or a substantial amount of his or her investment in the Programs; (iv) the Advisors participating in the AdvisorLink Program will have trading authority over an investor's account and the use of a single Advisor could mean lack of diversification and, consequentially, higher risk; (v) the Programs' fees and expenses will reduce an investor's gross trading profits, or increase gross trading losses; and (vi) there is no guarantee that the Programs will reach their goal of absolute returns.

Comparison to the performance of the S&P 500 Index, NASDAQ Composite Index and the Dow Jones Industrial Average is not meant to imply that investors should consider an investment in the ***Advisorlink®*** or Absolute Return Portfolios Programs as comparable to an investment in the different types of stocks that comprise each of these indexes.

This publication is not intended to provide any individual investment, financial, legal, regulatory, accounting or tax advice and nothing herein should be construed as a recommendation, by Halbert Wealth Management, its affiliates or any third party, to acquire or dispose of any investment or security, or to engage in any investment strategy or transaction. You should consult your own investment, legal and/or tax professionals regarding your specific situation.

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